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## Growth Investing

### *The other major investing system*

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As the stock market has broken through the past bear markets and rallied for six months now, growth-style investing has offered high returns. While I often focus on value investing when looking at the fundamentals, growth investing is the other major school of investment theory. Where value investors might look for bad news they think will improve, growth investors look for good news they think will get better.

Other main features of growth investing include looking for accelerating earnings which are ahead of their industry group, and whose earnings are should stay ahead of the market over a long period of time. The idea is that if those earnings do stay ahead of the market, so will the stock price. There are a number of growth strategies that aim at higher returns.

Peter Lynch was a famous growth investor who helped make putting money into mutual funds exciting. He did that by a combination of great returns for his Fidelity Magellan Fund and a straightforward way of explaining what he was doing that was popular with middle class investors

Lynch had a number of criteria he used when choosing investments. He looked for company's whose earnings per share were growing between 25-50%. He stayed away from those growing more than 50%, feeling that was too fast to be sustained over a long period.

He also used the PEG ratio, the current P/E ratio divided by the rate of growth in the company's earnings. P/Es are much higher now than they used to be, so it can be difficult to decide what an acceptable number is now. Since there can be big differences between different industry groups, I like to use the average for that sector.

On top of all that he added a few rules of thumb, such as whether he liked the store or product, and whether the company's annual reports had a minimum of pictures in it. In addition, he generally wanted a company's inventories to stay even with sales. Inventory that is increasing faster than sales is a red flag.

Another well-known growth investor is Martin Zweig, made famous when he called the Crash of 1987 on the Friday before the crash hit. He likes to see a company's earnings increase be relatively stable, such as a 20% increase in each of the preceding three quarters.

Like me, he also doesn't like a company that has a lot of debt. His rule of thumb for what a good P/E ratio is would be higher than 5, but not more than three times the current P/E for the overall market. In addition, he wants earnings growth to be accompanied by higher than revenue growth, and an increase in annual earnings for each of five years.

To get a good understanding on how to use the fundamentals for growth investing, I would recommend reading the book [How To Make Money In Stocks: A Winning System in Good Times or Bad](#) by William O'Neil. This covers a growth investing system he calls CANSLIM. CANSLIM is an acronym for a number of fundamental and technical factors. Those factors are:

- Current quarterly earnings per share: What is the right amount?
- Annual earnings increases: Look for meaningful growth.
- New products, new management, and new highs: buying at the right time.
- Supply and demand: small capitalization plus volume.
- Leader or laggard: Which best describes the stock?
- Institutional sponsorship: A very good sign.
- Market direction: How should it be determined?

Developed as a result of studying the past leaders of the stock market, CANSLIM is a strategy based on strict, disciplined investing rules for buying, selling, and holding stocks. One big advantage of the system, absent in many other growth (and value) investing strategies, is that it forces an investor into cash when the market is not optimal for holding stocks.

While there are many rules you must successfully apply in this kind of investment system, I like the top-down approach (like we use at OptionVue Research) where you first examine the general market and determine whether it is technically in good condition. This system also is close to our own philosophy by recommending you buy stocks on their breakouts above resistance levels, typically approaching new highs.

Like the style popularized in Investors Business Daily, a breakout is defined as a stock price increase to new highs on trading volume that is well above the average volume for the stock. In fact, the new edition of the book has a section explaining how to use their investors.com website.

Finally, to protect an investor from risk, the system stresses placing stops 7% to 8% stop below the pivot or buy point. This prevents you from riding a stock all the way down, as many investors did the past three years, often on the advice of their expert brokers. This also shows why it is important to keep a good mix of investments, from risky to conservative. Asset diversification has been shown to boost returns over the long term while simultaneously reducing volatility.

Because the stocks in growth funds tend to be expensive (meaning they have a high P/E ratio), growth investing is generally considered riskier than value investing style. Growth funds also tend to be more volatile than value funds. But both can produce strong results — or fail to. But rarely at the same time. Value investing generally pays off more in bear markets, when stock prices are depressed, while growth investing works best in quickly rising bull markets.